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A LA CARTE AND “FAMILY TIERS” AS A RESPONSE TO A MARKET DEFECT IN THE MULTICHANNEL VIDEO PROGRAMMING MARKET

Abstract: Many policymakers have recently expressed concern over the practice of multichannel video programming distributors (“MVPDs”) such as cable and satellite video providers, to “bundle” a large number and variety of channels together into a “take-it-or-leave-it” package. In this BULLETIN, we describe a set of circumstances in which a market defect will lead to the bundling of potentially objectionable content with generally desired content. Our model focuses on the role that advertisers and video programming vendors play in the network bundling of MVPDs. Our economic model illustrates the role these “third parties” play in an MVPD’s decision to deliver particular channels of video programming to households in a “forced bundle” of desired and potentially objectionable programming that does not give consumers the option to exclude objectionable programming from the purchased bundle. Forced bundles appear in both monopoly and competitive structures because the conditions that give rise to this market defect make these “forced bundles” resistant to changes in market structure. As a result, policymakers should look at all participants in the multichannel video distribution market, not just retail distributors, as potential sources of forced bundling problem.

I. Introduction

Many policymakers, both Republican and Democrat, have recently expressed concern over the content of video programming and, in particular, the practice of multichannel video programming distributors (“MVPDs”) such as cable and satellite video providers, to “bundle” a large number and variety of channels together into a “take-it-or-leave-it” package. It is common for MPVDs to make certain “must-have” programming (like CNN, ESPN,

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Nickelodeon or The Discovery Channel) available only to those consumers in an “expanded basic” bundle that also includes other channels like MTV and SpikeTV that might contain content that some subscribers may find objectionable.

FCC Chairman Kevin J. Martin has discussed this issue publicly on several occasions and has asked the MVPD industry to develop solutions that would give American households additional choice and control over the cable programming networks that they receive. In recent testimony before Congress, Chairman Martin discussed his frustration with increasingly indecent programming and the unavailability of “family tiers” of programming that exclude potentially offensive material.¹ Many consumers and some commentators have supported the Chairman’s initiative.² But Chairman Martin’s initiative has been criticized on the ideological ground that a governmental requirement that an MVPD offer a “family tier” or “a la carte” programming is an unwise and dangerous interference with free market principles.³ One institution has argued in particular that because it believes the MVPD market to be competitive, “cable and satellite operators have sufficient incentives, on a voluntary basis, to offer customers the services they want in the form they want them at prices that consumers are willing to pay for such services.”⁴

In this BULLETIN, we attempt to cut through the rhetoric and describe a set of circumstances in which a market defect will lead to the bundling of objectionable with desirable content.⁵ Our approach is practical and not philosophical – our purpose is to present an economic model illustrating the circumstances or conditions in which MVPDs might decide that it is more profitable to deliver particular channels of video programming to households in a “forced bundle” that does not give consumers the option to exclude objectionable programming from the bundle. Our analysis uncovers one set of conditions that makes these “forced bundles” resistant to changes in market structure, in that forced bundles appear in both monopolist and

¹ United States Senate Committee on Commerce, Science and Transportation, *Open Forum on Decency*, 109th Cong., 1st sess., S. Prt. 109-42, 2005, 9-12 (statement of Kevin J. Martin, Chairman, Federal Communications Commission).

² See, e.g., C. V. Conda, *Cable, à la carte?*, NATIONAL REVIEW ONLINE, 12 January 2006 (“Conservatives of all stripes should commend FCC chairman Martin for using the enlightening power of the Bully Pulpit”).

³ See, e.g., A. Thierer, “The Moral and Philosophical Aspects of the Debate over A La Carte Regulation,” *Progress Snapshot* (Progress & Freedom Foundation, 2005) (arguing that “you have no ‘right’ call [sic] upon government to upend an industry’s private business arrangements”).

⁴ For example, see Progress & Freedom Foundation Comments, *A La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, FCC MB Docket No. 04-207 (July 15, 2004) (hereinafter “PFF Comments”), 2.

⁵ By “objectionable” content we mean that a consumer has a negative utility from it.

competitive structures. Thus, policymakers must look to markets other than the retail multichannel video programming distribution market to identify the source of this “forced bundling” problem. Our findings suggest that investigations by both academics and government into the causes and consequences of forced bundling may be legitimate, since our model shows that consumer welfare is unambiguously improved with the elimination of forced bundles.

This BULLETIN is outlined as follows. In Section II, we present a brief background on the issue of a la carte and forced bundling in the purchase of video programming. Section III contains a simple economic model in which a third party (e.g., advertisers and programmers) compensates the cable provider for bundling certain undesirable channels with desirable ones. The presence of this third party does not, in and of itself, create a “market failure,” but it does interfere with the ability of consumers to communicate their bundling preferences to MVPDs and have those preferences fully realized. Rather than a “market failure,” we call this a “*market defect*,” but it is certainly a failure from the consumer's point of view.⁶ The influence of the third party is not alleviated by changes in market structure, as forced bundling is shown to be resistant to competitive entry.⁷ Since the transactions costs of organizing a coalition of consumers to pay for the exclusion of objectionable content are likely to be prohibitively high, an argument for the government to act as an agent is not unreasonable. Section IV outlines some potential policy responses, recognizing that any effort to resolve this problem with government intervention requires the policymaker to invest in fully understanding the sources and nature of bundling, so that any rules can be precisely targeted.

II. Background

Most consumers who purchase cable services purchase an “expanded basic” tier of channels, which is usually priced at a fixed monthly cost. Many of the most-popular cable programming services are found on this expanded basic tier – shows as diverse as “The Iron Chef” to “MythBusters” and “Poirot.” But the expanded basic tier also contains programming that some families – particularly parents of school-aged children – might prefer not to have available. For example,

⁶ The complete social welfare consequences of these practices are beyond the scope of our analysis. In particular, the role of advertising in any such evaluation brings with it the well-known welfare complexities identified in the seminal article by A. Dixit and V. Norman, *Advertising and Welfare*, 9 BELL J. ECON. 1 (1978).

⁷ As a result, our model shows that simplistic arguments that assert only that because the MVPD market is “competitive” the industry is only “offer[ing] consumers the video services they demand on the basis (*i.e.*, bundled or not) that consumers wish to receive them . . .” PFF Comments, *supra* n. 4 at 2.

- A recent show on MTV entitled “I’m on Steroids” documented one man’s attempt to get on the cover of a fitness magazine by taking steroids “under the supervision of professionals.”⁸
- Another MTV show, called “Homewrecker,” showed how to “Make Your Very Own Torture Room.”⁹
- SpikeTV sported an animated show called “Stripperella”, starring Pamela Anderson as the voice of Erotica Jones, “a stripper by night and superhero Stripperella by even later at night.”¹⁰

While no one forces consumers to watch programming they do not prefer, many have argued that the ready and easy availability of this type of programming to children creates important social problems and costs. Despite these opportunities, the fact remains that a family that wishes to have access to CNN, ESPN or The Discovery Channel, in the overwhelming majority of cases, must also accept access to MTV and SpikeTV as part of the bundle.

Defenders of the industry’s forced “bundling” of program networks contend that there is a form of cross-subsidy involved in this practice. A 2004 FCC report states that bundling of channels requires consumers to “cross-subsidize each others’ viewing habits, allowing new and diverse programming to survive in the marketplace.”¹¹ So, there is at least some consensus regarding cross subsidization motivations for bundling.

Perhaps the most perplexing thing about a la carte programming is why we see so little of it. Because a multi-tier strategy is a form of price discrimination, it would seem logical that the creation of a “family tier,” along with an “adult contemporary tier” or “scatological content tier,” if properly implemented, could generate higher profits for a firm. Yet this does not happen except in certain circumstances (notably, sports, movies, and Playboy/Spice, none of which contain channels generally available on the expanded basic tier level).

Similarly, with digital cable services, the ability to offer more a la carte programming, through pay-per-view or video-on-demand services, is certainly more cost-effective. In the days of analog cable service (which have yet to pass completely), high equipment or software costs to

⁸ <http://www.mtv.com/onair/dyn/truelife/episode.jhtml?episodeID=98389>.

⁹ <http://www.mtv.com/onair/dyn/homewrecker/series.jhtml>.

¹⁰ <http://www.imdb.com/title/tt0369171/>.

¹¹ Federal Communications Commission, *Report on the Packaging and Sale of Video Programming Services to the Public*, FCC MB Docket No. 04-207, (2004) (hereinafter “FCC 2004 A La Carte Report”), 5.

exclude particular channels from the bundle might have justified the sale of programming in large bundles. Analog cable systems often used filters and traps to block certain channels, but it was notoriously easy for consumers to circumvent those devices.¹² But, even in the days of analog cable, some programming was still sold on an a la carte basis, such as HBO. In a digital cable environment, however, the argument that it is difficult as a hardware, software, or enforcement matter to offer channels solely on an a la carte basis is weak. The technology for complete a la carte is now clearly possible – the fact that video services are not sold in this way must have a different explanation.

Section III below outlines an economic model to help explain why a cable firm would create bundles combining undesirable with desirable programming. This model shows that the presence of advertising revenues or some other off-setting factor, like programming distribution transaction costs, plays a significant role in setting the size of the expanded basic tier. Stated another way, MVPDs do not create their tiers of programming solely by reference to what consumers want to watch (or not watch) – an MVPD establishes tiers in order to maximize profits. Those profits include advertising revenues and programming licensing considerations, which, in essence, require that popular programming networks be bundled with new and niche channels. As a witness for one of the nation's largest MVPDs, the Dish Network, recently testified before Senate Committee on Commerce, Science and Transportation:

We've also considered offering a family tier, but are currently prevented from doing so by our existing contracts with programmers. . . . [L]arge content providers require the bundling of multiple core popular programming networks, only some of which would be considered family friendly. Again, in these circumstances, the programming vendors will not sell the family friendly channel or will only offer it at an uneconomic price, unless we agree to accept several of the vendors' other channels and place these other networks in the same programming tier.¹³

The intervention of third parties with market power in the exchange between the MVPD and the consumer can create a type of market defect that results in consumers purchasing programming that they would prefer not to receive. By "market defect" we mean that the forced purchase of undesirable programming will occur in both monopolistic and competitive

¹² So much so that the industry lobbied for "cable theft" laws that made it a criminal offense to disable a filter or trap and receive channels for free.

¹³ United States Senate Committee on Commerce, Science and Transportation, *Open Forum on Decency*, 109th Cong., 1st sess., S. Prt. 109-42, 2005, 34-35 (statement of David J. Moskowitz, Executive Vice President/General Counsel, EchoStar).

settings in the retail distribution market, and that consumers are unable to influence bundling decisions (in either of these competitive extremes). Thus, even if a market performs well by traditional measures, consumer surplus might be reduced by the “forced bundling” of offensive programming with desirable programming.

III. Model

Our economic model tries to explain the reasons why a MVPD would choose to sell programming to consumers only in “bundles” that contain programming that the consumer may not wish to purchase. The model shows that the presence of a third party, such as an advertiser or a video programming vendor (like Disney or Viacom), will result in programming carriage and bundling decisions that will be sub-optimal to particular consumers. Moreover, the analysis finds that this sub-optimal outcome occurs both in monopoly and competitive/contestable market conditions. As a result, one cannot simply posit that a “competitive” MVPD market will alleviate this problem.¹⁴

To make our model simple, assume we have two consumers (1 and 2) and two channels (A and B). Consumers value these products at V_{ij} (the value of channel j to customer i). The value V_{ij} can be negative – this means that the consumer does not like the channel and would consider himself to be better off if the channel were not piped into his home. The costs of delivering a channel to a household are given by the cost function $C(a, b)$ where a and b count the number of subscribers who get each channel. For example, $C(2, 1)$ implies the seller sells 2 units of channel A and 1 unit of channel B. Table 1 summarizes potential combinations of output and illustrative values of cost. Both scale and scope economies are present.

Table 1. Potential Costs with Illustrative Values

$C(1,0) = 5$	$C(1,2) = 10$
$C(0,1) = 6$	$C(2,0) = 8$
$C(1,1) = 8$	$C(0,2) = 9$
$C(2,1) = 9$	$C(2,2) = 11$

We impose the following conditions on the models. First, the values from the channels are additive, so that $V_A + V_B = V_{AB}$ (ignoring the consumer subscript). In other words, the values of the channels are independent. Second, costs do not vary depending on the identity of the customer.

¹⁴ See *supra* n. 4.

A. Example 1: When A La Carte Should Happen

It is easy to construct an example in which the cable firm would offer channels on an *a la carte* basis to the two customers. If customer values Network A at 10 ($V_A = 10$) and values Network B at -1 ($V_B = -1$), then the value of a bundle of Networks A and B to the consumer is 9 ($V_{AB} = 9$). Using the costs from Table 1, the cable company would generate a profit of only 1 by selling a bundle of A and B to the consumer ($C(1, 1) = 8$). An *a la carte* offering, however, actually increases the value of the cable firm's goods to this consumer (to 10) and reduces cable firm's cost to 5 [$C(1, 0) = 5$]. Thus, in this situation, *a la carte* pricing is more profitable than a forced bundle.

Importantly, the cost figures in Table 1 include a "discount" to the seller for offering both channels ($8 < 5 + 6$). Thus, even if each channel is more costly if purchased alone (or, there is some cost to exclude a channel), *a la carte* pricing is profitable. This is always true when the value of a channel is negative and the cost of the channel is positive.¹⁵

Example 1 shows two simple but important conditions that are critical for a *la carte* pricing to happen – the potential value from a *la carte* availability to the consumer must be *higher* than the value of a larger bundled product, or the cable firm's costs must be *lower* if its services were sold on an *a la carte* basis. These two factors are independent of one another. If a consumer truly despised Network B so that $V_B = -11$, then the cable firm's costs need not change at all for it to recognize the value of a *la carte* pricing. In this case, if a A/B bundle is created, then the consumer does not purchase the product because he assigns a negative value to the bundle. Even if the cable operator's costs from providing a *la carte* services for Network A (say, $C(1,0) = 9$) is higher than the cost of providing the A/B bundle ($C(1,1)$), then it might still find it profitable to make this option available to this consumer.

B. The Presence of a Third-Party

Video services are not bought and sold as described in Example 1. Importantly, third-parties (notably, advertisers and programmers) are part of the MVPD industry's profit calculations and cannot be ignored. Indeed, as noted above, one of the nation's largest MVPDs – the Dish Network – has publicly stated that the practices of programmers and advertisers may be most responsible for the failure of consumers to see a *la carte* programming.¹⁶ The presence of such a third party is important because it affects the revenues and profits of a cable firm that offers a menu of products. A third-party advertiser pays the cable or satellite firm according to

¹⁵ If the value exceeds the cost, then bundling is profitable.

¹⁶ *Supra* note 13.

viewers and/or subscribers, while a third-party programmer charges the cable or satellite firm according to subscribers.

For the following examples, let us assume that this third party (say, an advertiser) pays the multichannel video provider some amount $S_A \geq 0$ for each subscriber that receives Network A, and $S_B \geq 0$ for each subscriber that receives Network B.¹⁷ This *payment-per-eyeball* approach is generally consistent with the nature of transactions in the advertising industry.¹⁸ While we focus on the role of the advertiser in these examples, the same could be said for programming vendors that wish to sell a portfolio of cable programming networks to an MVPD. Several MVPDs have alleged that programming vendors “tie” the sales of all of their networks together that require that all networks be purchased and placed on the same tier, or that these vendors offer channels on an a la carte basis but only at higher prices. In this sense, an MVPD that wishes to offer multiple tiers or a la carte channels will face higher costs. That situation leads to similar decisions as to a situation in which an MVPD would receive lower advertising revenues if it offered more tiers or a la carte programming.

C. Example 2: Forced Purchase of Undesirable Channels Under Monopoly

Example 1 describes the situation in which the MPVD, in the absence of a third party, would be better off with a la carte pricing. In Example 1, bundling reduces the maximum price the seller can charge for a bundle and eliminating the channel reduces costs. As a result, the MVPD will not require the consumer to purchase Networks A and B in a bundle.

Now enters a third party that is willing to pay the MVPD if the consumer receives Network B (the network the consumer does not like) or the third party will increase the costs of the MVPD for carrying Network A if it does not distribute Network B on the same tier. As a result, the consumer’s willingness-to-pay (V) is not the only revenue issue for the MVPD. Whether or not to force the bundle on the consumer or offer a la carte pricing depends on which offers the greatest profits, and these profits are affected by a third party.

We can derive the relevant condition for forced bundling as follows. Say Consumer 1 likes Network A ($V_{A1} > 0$) and Network B ($V_{B1} > 0$), but Consumer 2 dislikes Network B ($V_{B2} > 0$, $V_{B2} < 0$). If so, the cable company has two relevant options: (1) it can force a bundle on both

¹⁷ The value of the advertisements, S , is a function of the viewership of the channel. We assume the objectionable channel is viewed by someone in the household. Indeed, that is nature of the problem at hand – the issue of children watching video programming that their parents would prefer they not have available to them.

¹⁸ J. Surmanek, *MEDIA PLANNING: A PRACTICAL GUIDE*, Vol. 3 (1996).

consumers or (2) it can offer only a bundle to Consumer 1 and a la carte pricing to Consumer 2 (what we call a “mixed bundle”).¹⁹

Which strategy is more profitable? To see, let

P_{AB}' = bundle price in a forced bundle;
 P_{AB}^* = bundle price in a mixed bundle;
 P_A^* = channel A price in mixed bundle.

The profit of the seller with a forced bundle (π_F) is

$$\pi_F = 2P_{AB}' - C(2,2) + 2S_A + 2S_B, \quad (1)$$

and with the mixed bundle is

$$\pi_M = P_{AB}^* + P_A^* - C(2,1) + 2S_A + S_B. \quad (2)$$

The difference in the profits is

$$\pi_F - \pi_M = (2P_{AB}' - P_{AB}^* - P_A^*) - [C(2,2) - C(2,1)] + S_B. \quad (3)$$

To clean up a little, let $C(2,2) - C(2,1) = IC_b$, which is the incremental cost of one more channel B.

The monopolist forces the bundle on both Consumers 1 and 2 if

$$(2P_{AB}' - P_{AB}^* - P_A^*) - IC_b + S_B > 0. \quad (4)$$

Since Consumer 2 has a negative value for channel B, presumably we have $(2P_{AB}' - P_{AB}^* - P_A^*) \leq 0$. If we accept this to be true, then $(2P_{AB}' - P_{AB}^* - P_A^*) = 0$ is as large as this expression can be. So, a necessary condition for forced bundling is $S_B > IC_b$; that is, the extra dollars from the third-party source (advertising) exceeds the incremental cost of providing the channel to Consumer 2. The larger is the distaste of channel B by Consumer 2, the larger S_B

¹⁹ W. Adams and J. Yellen, *Commodity Bundling and the Burden of Monopoly*, 90 QUARTERLY J. OF ECON 475 (1976). These are “relevant” options in that other options are less profitable.

must be to force the bundle. But if S_B is large enough, the bundle will be required even if Consumer 2 has a strong distaste for Network B.

Example 2 reveals an important concept – *if a MVPD receives revenues (S_B) from another source, like an advertiser, it may bundle programming to consumers that the consumer would prefer not to view.* In this sense, bundling of channels on an “expanded basic” tier is similar to unsightly billboard advertising – drivers and neighbors may dislike a billboard intensely but may not necessarily have a “say” as to the content or presence of the billboard, which is worked out between the property owner and the firm paying for the ad. Proponents of forced bundles admit that this practice occurs – they extol this “cross-subsidization” in which consumers pay for and receive programming they do not want as part of a bundle in order that other consumers can see that programming.²⁰

It is important to understand that S_B need not be additional revenue to a cable operator – it could represent lower costs (perhaps usefully thought of as a rebate on the price of programming). Consider the situation in which a cable operator is negotiating with a large programmer that produces a number of cable programming networks (like ABC/Disney or Time Warner). The programmer may offer all of its networks at a “take it or leave it” package that require that all affiliated programming networks be packaged as part of the expanded basic tier. A programmer also may structure the pricing of its channels so that placing only a few networks in the expanded basic tier but not the others would be prohibitively expensive for the cable operator. Packages including “must have” channels like network broadcast affiliates and ESPN exacerbate this practice. It has been alleged that the current broadcast-cable retransmission consent rules encourage and facilitate these arrangements, which has led to the proliferation of networks affiliated with the major broadcast networks like ABC Family and MSNBC. In these examples, S_B would represent the *avoided additional cost* that a cable operator would incur if it did not place Network B in the expanded basic tier. If that cost includes the inability to carry a local broadcast affiliate of ABC or NBC, then S_B would be relatively high and lead to a number of cases of forced bundling.

D. Example 3: Forced Purchase of Undesirable Channels Under Competition

It might be simple to assert that increasing the number of MVPDs would result in programming tiers more tailored to individual consumer tastes – and that if such tailoring of preferences does not occur and large “expanded basic” bundles proliferate in a competitive environment, then government should not worry about that result. But that argument fails to consider that some market defects persist even in the competitive markets. A closer

²⁰ See *supra* text and n. 11.

examination shows that the presence of third party advertisers and programmers directly interfere with the MVPD-subscriber relationship, and this interference is independent of market structure.

With large scale and scope economies, which is what we have assumed, competition is costly and, therefore, less likely. Nevertheless, our model can evaluate the effects of competition on bundling by using contestible market theory. In essence, contestible market theory suggests markets render results consistent with competition even if a monopolist serves the market. Or, contestable market theory assumes that because of the threat of competitive entry, firms will price so that they reap zero monopoly profit.

With zero profits, a firm selling a bundle in a contestable market (zero profits) would price the bundle accordingly

$$2P_{AB}'' - C(2,2) + 2S_A + 2S_B = 0, \quad (5)$$

so

$$2(P_{AB}'' + S_A + S_B) = C(2,2).^{21} \quad (6)$$

Now let us consider the question of a firm that seeks to enter the market and it is considering various pricing schemes, including a la carte. If the entrant sells Customer 1 a bundle of Networks A and B, then its profits are

$$P_{AB} + S_A + S_B - C(1,1) < 0; \quad (7)$$

the firm will not make money if the entrant tries to sell Customer 1 the bundle of Network A and B, and sells Customer 2 just Network A.

If the entrant tries to serve Customer 1 the bundle of Networks A and B and Customer 2 just Network A, its profits will be

$$P_{AB}^* + P_A + 2S_A + S_B - C(2,1) < 0. \quad (8)$$

²¹ Without price discrimination, we have $C(2,2)/2$ equal to average incremental cost.

Unfortunately for the entrant, this strategy is unprofitable as well. Example 2 shows that the incumbent will force a bundle of Networks A and B if

$$2P_{AB}'' - C(2,2) + 2S_A + 2S_B \geq P_{AB}^* + P_A^* - C(2,1) + 2S_A + 2S_B, \quad (9)$$

yet we know that the left-hand side of Eq. (9) is zero by Eq. (5) – that is, the incumbent has set its prices so that it is earning no super-competitive profits. As a result, Eq. (8) must be negative, so entry is unprofitable.

So, in a contestable market setting, an incumbent will be able to maintain a forced bundle against a competitive entrant. Competition at the local MVPD distribution level alone, under certain conditions, may not protect consumers from bundles of undesirable and desirable programming.

E. Impact of Bundling on Welfare

We have illustrated above that under some conditions, an MVPD might require a consumer to purchase programming networks he or she does not desire in order to obtain access to programming networks he or she wants. We find that this practice of “forced bundling” in the expanded basic tier can occur if blocking that channel increases the MVPD’s costs or if the presence of a third party (such as an advertiser or programmer) increases the revenues of a MVPD for these forced bundles.

The social welfare effects in the video programming industry are difficult to determine for a number of reasons. First, we have not formally modeled the market that produces the prices S . As part of this analysis, we must consider that the benefits to the advertiser of the customer contact (equal to at least S) and any effects on consumer welfare from the purchase of advertised products.²² Also, there may be direct costs experienced by the seller caused by providing the advertisement, and these costs offset the benefits to the advertiser in a welfare calculation.

What is clear about welfare, however, is that *consumer welfare* unambiguously rises if the consumer can avoid purchasing undesirable channels as part of a bundle. The interest in Chairman Martin and other policymakers regarding family tiers and a la carte solutions could

²² The value, positive or negative, of the actual advertisement (not the product advertised and potentially purchased) is included in V . In other words, if advertising has negative value, then V will be lower the more advertising content appears on the channel.

be seen simply as evidence that the interests and welfare of consumers are being articulated by policymakers.

F. Practical Issues

In our theoretical framework, we revealed that forced consumption of undesirable channels may be resistant to competition. Thus, even a well functioning market may fail to satisfy reasonable consumer demands (*i.e.*, not buying programming they find offensive), because third party advertisers and programming vendors affect the carriage and tiering choices that MVPDs make, and transactions costs effectively prevent consumers from participating in these decision.

This result is much like findings of economic theory that the relative quality of services provided between monopoly and competition is ambiguous.²³ In essence, a monopolist has an incentive to increase demand through quality improvements as do firms with rivals, and in some cases the incentive for quality is larger for monopoly. It is also similar to the inability of economic theory to provide compelling theoretical evidence that competitive firms are more efficient than monopoly firms.²⁴

In practice, however, we often observe that competition lowers prices, raises quality, and increases firm efficiency.²⁵ The failure of theory to produce these results in an unambiguous fashion is a shortcoming of theory, not of experience. So, while it is quite possible that competition may help resolve or mitigate instances of “forced bundling,” the risk (and reasons) that it might not should be thoroughly investigated.

IV. Thoughts for Policymakers

The preceding analysis shows that policymakers cannot simply make face-value assertions that consumers “always have the option of declining” to purchase cable programming,²⁶ or that

²³ M. Mussa, and S. Rosen, *Monopoly and Product Quality*, 18 J. ECON. THEORY 301 (1978); D. de Meza, *Product Diversity under Monopoly: Two High Quality Results*, 49(2) BULLETIN OF ECON. RESEARCH 169 (1997); L. Abbott, *QUALITY AND COMPETITION: AN ESSAY IN ECONOMIC THEORY* (1995).

²⁴ H. Varian, *Entry and Cost Reduction*, (University of Michigan, 1994), <http://www.sims.berkeley.edu/~hal/Papers/entry.pdf>.

²⁵ In the video industry, see R. Beard, G. Ford, R. C. Hill, and R. Saba, *Fragmented Duopoly: A Conceptual and Empirical Investigation*, 78 JOURNAL OF BUSINESS 2377 (2005); Government Accounting Office, *Telecommunications: Wire-Based Competition Benefited Consumers In Selected Markets*, GAO-04-241 (2004); Federal Communications Commission, *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, FCC MB Docket No. 04- 277, Eleventh Annual Report, FCC No. 05-13 (rel. Feb. 4, 2005).

²⁶ FCC 2004 A La Carte Report at 85.

because the “market is sufficiently competitive,” MVPDs will offer consumers bundles and tiers “in the form they want them.”²⁷ Instead, our analysis shows (a) that there is the potential for a market defect that may result in the distribution of programming to consumers that consumers would not otherwise choose to purchase except for forced bundling and (b) that consumers are effectively unable to do anything about it.

In particular, our model shows that in certain circumstances, a variety of factors may work in a manner that makes desirable video programming (like CNN and ESPN) available only through an “expanded basic” tier that also contains cable programming networks that a number of consumers prefer not to receive, let alone pay for. This circumstance can be the result of a number of conditions, such as an inability of consumers to contract with upstream content providers or other third-party interventions. It can also be caused by public policies that reinforce the ability of a video programming vendor to require that all of its affiliated video networks be placed on the same tier, without regard to whether certain of those networks may or may not be family friendly.

Because forced bundling can be the result of market defect or of public policy, it is legitimate for concerned policymakers to examine potential public policy responses. However, any public policy response should be targeted at the root causes or conditions that might lead to inordinate forced bundling. To the extent that policymakers believe intervention is required, a number of potential strategies can be utilized that are directed at the real source of forced bundling. While the current debate has focused on “family tiers” and a la carte programming,²⁸ we present a few additional strategies below. Other alternatives may exist, and the comments that follow are merely thoughts at this point, and we have not conducted any meaningful cost/benefit analysis of any the proposals. Nevertheless, we believe it is worthwhile to initiate the discussion of some potential solutions.

A. *Revenge of the “Clickers”*

One reason that this market defect is unresolved is because it may be difficult for individual consumers to express their strong preferences directly to advertisers and cable companies. Advertisers certainly do not wish to pay to advertise on networks that a consumer does not

²⁷ PFF Comments, *supra* n. 4 at 2.

²⁸ One might consider a requirement for a “family tier” of programming as akin to a local zoning regulation that instructs bars close to residential neighborhoods to turn their music down after a certain time, or a law that limits the sale of tobacco or adult magazines within a certain distance of a school. It is hard to characterize this type of public policy intervention – decisions representatives make every day – as constituting “the conceit of a regulator and central planner.” See, A. Theirer, “False ‘Choices’,” *Progress Snapshot* (Progress & Freedom Foundation, 2006).

watch, but advertisers are not concerned with a parent's objections to particular programming as long as their kids watch it and buy the advertised products.²⁹ Because information is imprecise, advertisers will, almost by definition, pay the cable operator or programming network some fee to deliver a programming network to a subscriber – even if that subscriber (or a parent of a viewer) finds the content on that network offensive. Also, even a small probability that a consumer's attention is captured by a channel that is generally objectionable renders some value to advertisements.

Placed in terms of the model, S is made larger because of inefficiencies in the advertising market. As we describe above, if S_B (the revenue from a third-party advertiser that a cable firm receives by including Network B on its expanded basic tier) is large enough, the cable operator will force a bundle that includes Network B even if that consumer dislikes Network B ($V_B < 0$). The consumer is less satisfied with the product he or she receives, but still subscribes as long as the value of the other programming on the expanded basic tier (V_A) is large enough.

The problem could be overcome if all of the consumers that find Network B objectionable could somehow organize and compensate the cable operator for blocking Network B. But organizing such a diffuse constituency is likely to be so costly that success will be unlikely. When transactions costs of organizing a constituency are high, some people feel that the government should rightfully act as a representative, thereby overcoming transaction costs. A mandated "family tier" or a la carte availability could be seen as a governmental effort to overcome these transactions costs, as their availability would give consumers the opportunity to opt-out of programming they deem objectionable. In doing so, that decision will communicate to cable operators, programmers, and advertisers that this portion of the market is not interested in viewing particular content. Reducing transactions costs in this manner is one reason why government exists.

B. *Anti-Tying Provisions*

A more aggressive policy might forbid the "tying" of the distribution and carriage of one programming network to an agreement to carry another programming network on the same tier. While there is a vigorous debate over whether mandated family tiers and a la carte options are a sensible solution, a host of MVPDs and certain programming interests alike believe that the actions of large programming vendors results in expanded basic tiers that essentially encourage the proliferation of forced bundles of cable programming networks. Policymakers

²⁹ Advertisers, of course, do not generally care if consumers do not like the channel; advertisers only care if the channel is not watched. Stated simply, what parents would like their children to watch and what their children actually watch are two different things.

should pay attention and immediately examine whether current law encourages this development.

Unlike mandated a la carte, intervention in the wholesale market for MVPD programming may only need to be incremental to cause vast improvement. Government may not need to prohibit all forms of tying – policy may only need to prohibit tying that stipulates that the “tied” network be placed on the expanded basic tier in order for the MVPD to avail itself of a bundled price. Such a rule would permit MVPDs to create a variety of programming tiers that might result in placing, for example, ABC Family on a “family tier” and ABC’s SoapNet on an “adult tier”, rather than have pricing essentially force the MVPD to place both on the “expanded basic” tier.

C. Analyze Public Policies that May Reinforce Third-Party Intervention

Public policy itself may actually strengthen and reinforce the third-party intervention by advertisers and video programming vendors that we discuss above. For example, federal broadcast retransmission consent rules permit and, indeed, may potentially encourage broadcaster to bundle “expanded basic tier” carriage of affiliated cable programming networks with the authorization to retransmit the open-air signals of broadcast network affiliates. The Dish Network asserts that retransmission consent policies have resulted in the proliferation of basic-tier cable programming networks that are affiliated with existing networks or broadcast outlets. Federal retransmission consent rules require broadcasters to negotiate in good faith with MVPDs with respect to carriage of their signals, but despite requests from MVPDs, the FCC has not found that tying the carriage of broadcast network outlets (like a local ABC affiliate) to the carriage of affiliated cable programming networks (like the ABC Family network or SOAPnet, which shows reruns of ABC soap operas) on the expanded basic tier.³⁰ Even programming vendors have asserted that these retransmission consent policies result in a higher-cost and large expanded basic tier.³¹ We recommend that prior to any intervention in the market, policymakers should examine and remove existing policies that contribute to the problem.

³⁰ See 47 U.S.C. § 325, 47 C.F.R. §76.64.

³¹ See, e.g., Reply Comments of Turner Broadcasting System, Inc., *A La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, FCC MB Docket No. 04-207 (2004), at 17; Discovery Networks *Ex Parte* Presentation, *A La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems*, FCC MB Docket No. 04-207 (Oct. 14, 2004) (arguing that retransmission consent policies result in forced carriage of cable programming networks affiliated with broadcast networks that displaces services that subscribers would prefer).

V. Conclusion

Policymakers have expressed increasing concern that the “expanded basic” tiers of cable and satellite MVPDs often include programming that may be unsuitable to families with children. This discussion has prompted a number of proposals for solving this issue, but FCC Chairman Martin’s November 2005 proposal for family tiers and a la carte pricing in November 2005, attracted a particularly virulent firestorm of criticism.

Notably absent from this debate has been a practical, analytical analysis as to what market conditions would cause the proliferation of “expanded basic” cable programming tiers that effectively force consumers to allow into their households video content to which they object. In this paper, we take a practical – and not ideological – approach to this issue. We find that the proliferation of “expanded basic” tiers may be the result of a market defect caused by the operation of the upstream video programming and advertising markets. In short, the content, size and price of expanded basic tiers is *not* solely the result of MVPDs providing to consumers programming that consumers demand. As a result, American families are often faced with the unpleasant reality that in order to obtain access to programming they may desire (like CNN or Nickelodeon), they may be required to subscribe to programming that they do not want their children to see (like MTV or SpikeTV).

This BULLETIN explores the circumstances in which this form of market defect might impede that optimal mix or selection of programming choices to parents by multichannel video providers. In our view, “family tier” or “a la carte” requirements might be a valid public policy response to a failure of the market to increase consumer welfare by providing adequate choices.

Finally, it is important to note that the potential the market defect we identify here simply means that firms operating pursuant to market forces and the profit motive, may take actions that are not socially optimal. We do not mean to imply that these firms are “up to no good.” Nevertheless, it is the responsibility of policymakers to understand situations in which the market acting alone may not be adequate to promote the interests of consumers, and to intervene accordingly.